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GROUP LENDING EXPERIENCES IN REACHING SMALL FARMERS

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Introduction

The rural poor in many low income countries (LICs) have received very little formal credit. To improve their share these countries have introduced one or more of such reforms as supervised credit programs, concessionary interest rates, special credit institutions, group lending, loan insurance, and credit reservation. This paper deals with the experiences of one of these reforms, namely group lending in the Dominican Republic, Ghana, Malawi, Bolivia, Philippines, Thailand, India, Nepal, Sri Lanka and Bangladesh. Based on the analysis of these experiences we attempt to show that the potential innovative[1] nature of this reform is greatly constrained by the simultaneous pursuit of policies characterized by the concessionary and inflexible interest rates, lack of balance in developing credit and other services, and the inadequacies in the performance evaluation norms for the bank staff. Before we present this analysis we briefly compare justification for and features of this reform with those of the cooperatives patterned after the Raiffeisen model.

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Rationale and Features of Group Lending and Cooperative Reforms

Both these reforms have been introduced to improve the rural poor's share in the formal credit. They have been chosen for both economic and non-economic reasons. But there are some important differences in the emphasis attached to these factors.

Cooperative reform, unlike the group lending, was prompted from a concern to organize a force to counter the usurious power of the village moneylenders.[2] Private commercial banks were not preferred because they were also considered implicit and indirect partners of the usurious rural credit environment. Unless an organization based on the village community participation was developed, it was believed the virtues of self-help, thrift, and modernized attitudes[3] which are necessary to deal with the local moneylenders could not be promoted. This is not to suggest that the consideration of high costs and high risks of rural finance operations did not motivate the cooperative movement. Indeed, the features of administration by honorary management and local participation, unlimited liability of the members, and small and simple operations were to help reduce these costs and risks.[4] Another feature was that these cooperatives were to receive state partnership in both equity-capital and administrative leadership.[5]

Group lending unlike the cooperatives had its immediate origin in the collateral related difficulties[6] experienced by the existing formal agencies in the rural financial market (RFM). Neither the clear and heritable land title nor the guarantee of the reputable third party nor the hypothecation of reasonably "assured" anticipated crops produced could be available from the rural poor. Under these conditions the rural poor's dependence on the informal credit agencies continued to persist. Even when these conventional collaterals were available they could not be used to foreclose the loan when necessary because of legal, political and economic difficulties in enforcing the contract. The joint liability principle of group lending was considered to act as a substitute for the conventional collateral. In some countries like Ghana, tangible collateral in the form of land or some other property was taken from one of the members of the group. Other members were required to sign a promissory note only. Peer pressure and collective responsibility were combined to reduce the default risks.

Because of such reliance on local participation and unlimited liability, this reform is sometimes considered a pre-cooperative concept. It must, however, be recalled that some of these features were more clearly applicable to the early cooperative movement. In the later period large sized societies with their limited liability were organized mainly to improve their financial viability by enlarging the scale of operations.[7]

But the concern to reduce costs of rural finance operations through group lending was also strongly shared. This was considered necessary to overcome perceived barriers to financial intermediation between the rural poor and the formal lenders. This perception is based on three inherent features which characterize economic activities of the rural households. These are small size, riskier enterprises, and the mismatch between cash inflows and outflows. Even rural households perceived these as barriers to an entry in the formal market.[8] Thus, what is not explicitly considered for this reform, unlike the cooperatives, is the motive to create a force to counter the village moneylenders. Similarly, state participation in equity capital was not considered, though this reform has also state assistance in the form of extension, input supplies, and more importantly concessionary refinance.

Functions of Group Lending

From the preceding it is clear that the immediate functions which group lending reform aims to accomplish are:

1. Reduction in the lender transaction costs;
2. Similar scale economies in the provision of related technical assistance and other services which promote productive use of additional liquidity resulting from a credit transaction;
3. Reduction in loan default risks on account of peer pressure and joint responsibility; and
4. Reduction in the borrower transaction costs.

Have these functions been realized, and what may explain the results of this experiment may now be examined. Before we attempt this we must clarify that these questions cannot be uniformly examined for different countries. This is because in some of the countries group loans have been provided to those who did not have any access to formal credit. Though most studies have relied on informed judgements about the changes in lender costs, some have quantified both borrower costs and loan delinquencies. Some studies did not select non-group individual borrowers as a "control" to compare with the group sample. Some others though, selecting such a sample, did not test the differences between the two samples to attribute differences in their results to factors other than the borrowing status.[9] Despite these differences, the results of the group lending experiment are remarkably consistent across the countries.

Results of Group Lending

When the above mentioned functions are satisfied, conceptually, there should result an expansion in this program. This expansion could be measured by the growth in the number of group accounts, and also in the average loan amount transacted.[10] It can also be evaluated by quantifying the changes in the flow of credit in favor of the rural poor. Measuring performance in this manner would require time-series data on the implementation of this reform. Most country studies have utilized cross-section data for a year or two. Consequently, these indicators cannot be used. Alternatively, the results could be evaluated by directly studying what has happened to each of the four functions. To this we now turn.

Lender Costs: All the country studies except the India study report that the financial institutions aimed at reducing their costs through this reform. The study on India reveals that the concerned bank did not pursue this aim, though it does report the bank's experience in this regard.[11] All these studies except Ghana and the Philippines report inconclusive results about these costs. The Ghana study reveals lower costs for group loans, while the Philippines study reports higher costs. However, the lender costs could be higher for group loans in most countries if the costs of forming groups and providing other services are also added to the conventional transaction costs of lenders. These other costs are invariably borne by agencies other than the lenders. For example, in the Dominican Republic both these costs are borne by the refinancing agency: the Dominican Development Foundation. In other countries costs of providing technical services are borne by the government and the society at large. The only exception is India where these costs are shared by the lender and the government. But in most countries costs of forming groups are shared by the lenders, borrowers and the government.

Lenders in the Dominican Republic, Bolivia, India and the Philippines have enjoyed scale economies in making group loans, though a similar advantage is not experienced in the collection of these loans. But the Malawi lenders seem to have experienced this advantage. It is, however, not known whether the same holds for costs in making group loans. Such partial gains may not be ehough to induce lenders to undertake other services. Ironically, however, the implied lender behavior of shifting costs to the government/society/borrowers does not prove beneficial to the lenders. This is because when these non-conventional lending costs are borne by others they cannot possibly promote corresponding gains by way of better loan recoveries and larger turnover of loanable funds. Instead of relying on others to form groups which are homogenous and similar to non-group borrowers, lenders themselves could do this by using the existing village organizations or traditional informal groups to reduce the costs by forming groups. Such responses are not found in most countries except perhaps in Nepal and Turkey. The implied myopic view of the lenders might have originated from the inappropriate interest rate policies. The discouraging influence of such policies gets compounded in an environment of high inflation rate, stagnant rural productivity, and agricultural input/output price distortions.

Scale Economies in Other Services: Most lenders have not seriously attempted to reap this particular benefit of group loans. Whatever such loans which have been administered by them have not resulted in "organizational good"[12] for non-credit services including savings mobilization. Indeed, these loans have been provided to give an access to credit alone.

The only exceptions being Nepal and Malawi where the lenders required in lieu of down payments, a deposit of 5 to 10 percent of the value of group loans as "security fund." These deposits carried interest earnings for the group. They were also used to cover shortfalls in the repayment of group loans. It is claimed that such additional "organizational good" derived by the group members in Malawi and Nepal have resulted in better loan repayments, besides the group solidarity and sustainance. However, these country studies do not provide any data to judge the costs of administering deposits in the manner just described. Similarly, the country studies do not give any clue as to the costs advantages to other agencies which provide non-financial services. In the absence of experiences in providing these services by the lenders it is not possible to assess the need for compensatory gain, besides the individual pay-off, to develop an "organizational good." The multi-functional role[13] implied in providing other services including savings deposit collection may not have developed in most countries because of lack of appropriate incentives to the financial institutions.[14]

<u>Default Risks</u>: What is described so far about the two functions of group lending holds for this particular function also. The lower delinquency rate experienced in the initial years in the Dominican Republic did not sustain in the future. Even in Nepal and Malawi, if group loans were not tied with the deposit requirements, the delinquencies would be higher. Similarly, higher default rate of the group sample as compared

with the non-group sample in India was more because the former cultivated low productivity crops and had distant proximity to the bank. Repayment record of group loans in most countries was poor even though the reform required the non-delinquent members to repay the loan of the delinquent members.[15] In practice, most lenders found it difficult to enforce this requirement. This may be because of lack of legal sanction to the joint liability principle. More importantly, it could be because of lack of other "organizational good" for the group members. In the absence of such good the lenders cannot exercise any leverage to promote peer pressure as a substitute for the conventional collateral. Poor and delayed lender services have also lead to higher delinquencies in Bolivia, the Philippines and the Dominican Republic. Without appropriate lender incentives, neither the multi-functional role nor the better quality and timely services can be achieved.

Borrower Costs: Group borrowers enjoy cost advantages by saving fees for registering a collateral, formal and informal expenses to obtain the certificates needed with the loan application and by saving transportation and time costs of visiting the lenders. In the Dominican Republic and Bolivia, members of groups informally collected money to cover expenses for leaders who negotiated the loan. In some other cases these costs were shared by members by rotating the group leadership.

Most country studies except India and the Philippines report borrower costs to be lower for group loans. In the case of India, the higher costs to group borrowers were, however, due to differences in the distance and technology factors rather than the differences in the borrowing status of the two samples. When these differences were accounted for, the borrower costs were lower for group loans than for individual mortgage loans. This cost advantage would have been still larger had the bank not required separate loan application from each member of the group.[16] Even the lender would benefit from such change in the loan execution process.

In the Philippines the borrower costs were higher because of lengthy and complex loan procedures which necessitated the group borrowers to temporarily borrow from moneylenders at very high interest rates. While these borrowers in the Dominican Republic could benefit from the lower transaction costs, their gains would have been significantly larger had they received loans in time to avoid temporary borrowings from the money-lenders. But the complex and lengthy loan procedures would persist despite financial cost disadvantages to the lenders, again, because suitable incentives to the financial agencies are lacking.

Such loan procedures partly explains group members disil-lusion with this reform. This perception would also exist, despite lower borrower costs, when members are refused future loans because of delinquency by some other members or when members are forced to attend meetings without receiving compen-satory gain besides the credit. Borrower gains from a group loan reform can be perceived differently by different members. To a relatively well-off farmer, a group loan may be a reward for patronage, while to a poor farmer it could represent an independence. When groups consisting of such farmers are formed they may not succeed. Even a comparatively homogeneous group is unlikely to sustain if its maximum size is not controlled[17] as is the case in most LICs and if its members do not receive compensatory pay-offs, besides individual gains, from the collective responsibility. Providing such pay-offs to the group members may not be possible without undertaking a multi-functional role including savings deposit collection. And, to repeat, such roles cannot be performed when lender incentives are lacking.

Concluding Remarks

High transaction costs and high default risks are considered to be the twin problems of reaching small farmers in the RFMs. Both cooperatives and group lending reforms have been experimented with by many LICs to overcome these problems, though the former was also introduced to counter the force of the village money lenders.

By examining the experiences of group lending in some LICs this paper has shown that the potentiality of this reform in reducing the delinquency rates, lender costs and borrower costs do not seem to have been consistently realized in these countries. Partial gains either to the borrowers or lenders would not sustain this reform. Such results could be attributed to policies which overemphasize concessionary and inflexible interest rates and underemphasize the provision of financial services other than credit. Like the cooperatives, again, group lending would not be able to improve the rural poor's access to the formal segment of the financial market, unless this policy imbalance is corrected.

NOTES

1. Financial innovation is conceptually defined as that reform which facilitates providing and/or acquiring financial services at lower transaction costs. In practice, as will be seen in this paper, such innovations for a product like "financial services" is difficult to achieve. This is because this product being fungible, divisible and homogenous in nature it can be used to shift the cost to any agent including government or society involved in the intermediation process.
2. To quote from a study on cooperation in developing countries, "A primary motive for establishing cooperatives in developing countries is the desire to end the exploitation of large parts of both the rural and urban population by usurious moneylenders" (Engelmann, 1968, p. 86). Also, see Hough, 1966; Catanach, 1970; Carroll, 1969; Flores, 1969; and RBI, 1954.
3. To quote from a study on Asia, ". . .the farmer is backward and hostile to innovation and that therefore he should be stimulated to change, through various means like cooperatives, . . .," (Etienne, 1969). Also, see Engelmann, 1968 and Catanach, 1970.
4. For example, see Schiller, 1967 and Belshaw, 1959.
5. For example, see Hough, 1966; Engelmann, 1968; and Singh, 1970.

6. Such difficulties can be of two broad types. One is related to the very size of the collateral, and the other is related to the quality of the collateral. The former has typically prevented term loan transactions, since size of farm owned by a farmer makes him eligible to borrow amounts smaller than required to purchase the farm assets like a well, a diesel engine or an electric motor. In some countries, under these conditions, full term loans are provided by pooling collateral from more than one farmer. Such loans are, however, not treated as group loans for the purpose of this paper.

7. See, for example, RBI, 1954.

8. For an extensive treatment of how these barriers retard financial intermediation in both informal and formal RFMs, see Desai, 1980(a).

9. These observations suggest a need for studies which are based on a firmer conceptual and methodological framework. For some illustrations on this for cross-sectional analysis, see Adams et al., 1979; Adams et al., 1980; Matienzo, 1978; and Desai, 1980(b).

10. Such a measure would follow from cost advantages to both the lenders and borrowers, assuming other things remaining the same. It is also implied when financial innovation is treated in the sense of causing "net" shifts in both loan demand and supply schedules. See Desai 1980(b) for this, and see Smith, 1971 for defining financial innovation in terms of shifters in the appropriate functions.

11. This study being a pilot study was restricted to only one branch of one of the 14 nationalized commercial banks which have experimented with group lending.

12. "Organizational good" is defined as that good which is not available unless the potential beneficiaries organize themselves to procure it.

13 The need to provide services other than credit arises from the fact that delivering credit in isolation of such other requirements as extension, marketing, depositing excess liquidity, etc. is self-defeating to the objective of improving incomes of the rural poor. It is also needed to effectively compete with the informal credit agencies which frequently embody these services in their credit contracts. This is not to suggest that formal agencies should undertake all kinds of other services. Basically, they should emphasize provision of commercial services. Making available credit and savings deposit services is fairly straightforward. But providing marketing services would require some innovations like promoting supply of working capital credit to one of the group members or a local merchant(s) who may also form a part of the group. Such dealer credit could be given not only to stock and purchase commodities but also to promote sales.

14. This could very well be the reason for the failure of credit cooperatives in becoming multi-purpose societies.

15. The repayment record for the Ghana program is reported to have improved in the subsequent years. This may partly be because of combining tangible collateral and peer pressure.

16. Such procedure implied obtaining signatures of all members on every loan application since they were guarantors for each other. It also additionally implied executing documents separately for all the members at the time of loan sanction. Even though the bank did not pursue the lower lender cost advantage through group lending, such a procedure is not justifiable since it increases borrower costs too.

17. This is necessary to accomplish better distribution of compensatory gains for a successful group action. See Olson, 1973.

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